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DEPARTMENT FOR EUR/ERA, EUR/SCE, AND EEB/IFD; TREASURY FOR
INTERNATIONAL AFFAIRS LARRY NORTON

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SUBJECT: CROATIAN ECONOMY BACKED INTO A CORNER

¶1. (SBU) SUMMARY. The Economics Institute of Zagreb (EIZ), a key independent government think tank, has released a negative 1.4 percent growth forecast for 2009, the first domestic institution to forecast negative growth for the country. Press were quick to publish headlines of recession, leading to greater anticipation of a package of anti-recession measures the Prime Minister ordered from his economic council (of which the director of EIZ is a key member). At lunch with econoffs on January 29, the EIZ director privately told us there are few recommendations the council can usefully make that the government could undertake. There are no budgetary resources available to stimulate the economy, new credit will be very hard to come by, and the central bank cannot afford to let the exchange rate fall. We asked her whether the government could continue to avoid the prospect of IMF financing, at least until after the local elections in May. While she didn't say IMF intervention was inevitable, she replied that government finances and debt obligations could easily reach a crisis point well before the elections. In a meeting with foreign ambassadors last week, the Vice Governor of the central bank was more confident the government's financial obligations were manageable, at least for the first half of the year. END SUMMARY.

GOVERNMENT LOOKING TO ECONOMIC COUNCIL TO SAVE THE DAY

¶2. (SBU) The government has called on its recently-convened economic experts' council (of which the EIZ director is a leading member) to provide anti-recession recommendations this week. Privately, EIZ told us there is no traditional anti-recession measure, either fiscal or monetary, that the government will be able to undertake. New stimulative spending is not an option with the budget in its current form, but meaningful revision of the budget will be extremely difficult in the current political environment. New credit will be very hard to come by given the high stock of foreign debt. The kuna has to remain relatively stable to avoid severe pain from the high number of euro-denominated loans outstanding. She expressed frustration with the task given to the council and the fact that the government and press are now looking to them to provide a magic bullet. Instead, she said the Institute plans to offer suggestions aimed at simply shoring up economic stability.

BUDGET MUST BE REVISED

¶3. The budget agreement hashed out between the government and unions in December has already proven to be unrealistic. Revenues in January are already sharply down, and a Finance Ministry State Secretary publicly admitted earlier this week that growth figures lower than the budget's 2 percent forecast were likely, and would soon require a new budget.

The opposition SDP presented their own anti-recession package late last week including a new bill calling for a civil servant wage freeze. A similar proposal by the HDZ government in December to abandon a 6 percent wage increase called for in the collective bargaining agreement went down to defeat after strong union opposition. The government's latest deficit financing plan calls for a large 750 million euro syndicated loan to be secured in the middle of the year. According to the EIZ director, tight foreign credit and a rising risk premium could make the rate on such a loan difficult to swallow, if such financing would be available at all.

CONTINUING DEBT SERVICE CONCERNS

¶4. The Vice Governor of the Croatian National Bank (HNB) recently told a group of foreign ambassadors that Croatia's debt obligations are manageable, at least for the next six months. The HNB recently lowered its reserve requirement in order to free up 800 million euro for the government to borrow from domestic banks to cover a large portion of its foreign debt service obligations (total obligations for 2009 in the government sector are estimated at 1.23 billion euro). Private sector foreign debt continues to rise faster than the government sector and could pose an even greater challenge to the economy. The stock of private sector debt rose last year 15 percent to over 27 billion euro. Debt servicing obligations for the private sector in 2009 are estimated at over 8 billion euro. Many banks and companies have told the EIZ privately that they have individual strategies they are confident will help them weather the crisis, but none have been willing to reveal exactly what

those strategies may be. According to EIZ, exchange rate pressure alone has been responsible for a 10 percent deterioration in the debt/GDP ratio, which now stands at nearly 100 percent.

THE CENTRAL BANK HAS LITTLE FLEXIBILITY WITH THE KUNA

¶5. A managed currency depreciation to spur the export sector and improve Croatia's trade balance is not an option for the HNB, according to the EIZ director. With a large proportion of private sector loans denominated in euros, and currency clauses in most loans that pass exchange rate losses on to the consumer, a depreciation of the kuna would be too painful for the economcy to bear. A depreciation might also be of little utility in rebalancing trade, since many of Croatia's highest value manufactured exports, such as shipbuilding, are composed mainly of inputs imported from abroad. The kuna is sliding against the euro, but the HNB is determined to do what it can, recently expending 328 million euro of its foreign currency reserves to halt the slide (this in comparison to 1 billion in reserves it spent for this purpose during all of last year).

A FEW BRIGHT SPOTS

¶6. The EBRD, which holds the largest development lending portfolio in Croatia, recently praised Croatia's overall reform path, and said the economy was still well positioned for long term growth (despite the EBRD's own zero percent growth forecast). The EBRD also announced it will make as much as 300 million euro in new credit available, targeting small and medium enterprises. HNB's stock of foreign reserves remains significant, around 9 billion euro (although further pressure on the kuna this spring could certainly deteriorate their position). The banking sector remains stable by all accounts. The banks are well capitalized, deposits are strong, and domestic credit is still available (although rates are rising).

¶7. COMMENT: The qualified optimism of the central bank and the EBRD on debt servicing and long-term growth prospects suggest Croatia is better positioned than many to avoid long-term damage from the crisis. But in the short term, there are few good options for the economy, and little or no margin for error. We can expect some attempt at a budget revision soon. We still believe the government will do all it can to avoid the IMF, at least until after May's local elections, but it was sobering to hear the view of one of Croatia's more influential economists at the EIZ that things could spin out of control well before then. She also told us, though, that negative 1.4 percent growth could easily turn out to be much better than the recessions faced by other countries in the region. That's what passes for good news these days in Croatia. END COMMENT.
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